# 2 Introduction to Bookkeeping

LEARNING OUTCOMES

After reading this chapter, you should be able to:

- understand the basic terminology used in accounting
- identify the generally accepted accounting principles (GAAP) and understand the accounting standards for private enterprises
- define the categories of accounts—assets, liabilities, owner's equity, income, and expenses—and classify accounts by category
- create an opening balance sheet for a firm
- demonstrate an understanding of the accounting equation

You probably have some experience with basic bookkeeping if you keep track of the balance in your personal chequing account. However, using such a simple method in a business would be inadequate because it does not provide the information needed for making business decisions. Your business records must show where money came from and how it was spent in much more detail. Throw into the mix a trust account with money that belongs to your clients, and you will quickly see the importance of a good system of record-keeping. With the increased popularity of electronic banking and the use of debit cards, it is easy to lose track of funds received and funds paid out.

As a legal professional, you do not want to have cheques returned by your bank for insufficient funds. You always need to know what is going into and coming out of your bank accounts on a regular basis. Remember that the bank balance you view online might not accurately reflect how much money you have in the bank, because some cheques may not yet have cleared. Keeping accurate records will not only help track your actual bank balance, but also help you plan your spending over the next period.

# What Is Accounting?

Accounting is the language of business. You may wish to communicate financial information about your business to various **stakeholders**, each of whom has a different interest:

- **Internal users** are interested in managerial accounting. People working in the business need to have financial information for making management decisions. Is the business profitable? Can the business afford to expand? The user wants information that is as accurate as possible to help make appropriate decisions.
- **External users** are interested in financial accounting. People who lend money to the business will want to review its financial statements to assess the risks associated with a loan. Usually, the owner wants external users to think the business is doing very well and is profitable. The Law Society of Upper Canada uses the information generated by the firm to complete audits and to ensure that its bylaws are being followed.
- **Government users** are interested in tax accounting, and businesses are required to submit income tax returns annually. The owner usually wants to present less profit on its financial statement in order to minimize tax liability.

Business owners communicate information using financial statements prepared in keeping with generally accepted accounting principles, described in the next section.

# Accounting Standards for Private Enterprises

Effective January 1, 2012, accounting has been restructured to move away from a single financial reporting framework, formerly known as generally accepted accounting principles, to implement a variety of rules for different types of organizations. For example, Canada adopted the **International Financial Reporting Standards (IFRS)**, which is a set of international accounting rules imposed on corporations whose shares are listed on a stock exchange. In the case of not-for-profit organizations, the standards for these entities are set out in part III of the *CPA Canada Handbook: Accounting*.

Paralegals are concerned with the standards set out in part II of the handbook regarding **accounting standards for private enterprises (ASPE)**. Financial statements must present fairly and in accordance with Canadian **generally accepted accounting principles (GAAP)** the financial position, results of operations, and cash flows of an entity.

These standards apply to sole proprietorships and small private enterprises with a view to ensuring that bookkeeping records and financial statements are prepared using acceptable accounting practices. The standards ensure that everyone prepares and interprets financial reports the same way. Such consistency enables users of the information—including paralegals, lawyers, lenders, auditors, and regulators such as the Canada Revenue Agency and the Law Society—to rely on the financial statements and information presented.

Some examples of common accounting standards that paralegals should adhere to include the following principles.

- *Business entity principle.* Every business should be treated as a separate unit for the purpose of keeping accounting records. You should not mix personal and business transactions. Separate bank accounts should be used for personal and business activities. Personal expenses should not be recorded as expenses in the records of the business and vice versa. It is good practice to have separate credit cards for your business and for personal expenses for record-keeping purposes. For example, it would be a breach of this principle to take a spouse out to a movie and charge it to the business credit card and claim it as a business expense.
- *Conservatism principle.* A business should report moderate and realistic financial information to prevent overvaluation.
- *Consistency principle.* The same accounting methods must be used period after period.
- *Going concern principle.* A business is presumed to continue its operations for the foreseeable future.
- *Cost principle.* Assets purchased are recorded at their actual cost. Even though you may have paid $10 for a painting at a yard sale that you believe to be worth $1,000, the business records should show the painting's value at the amount that was actually paid.
- *Revenue recognition principle.* Revenue is recorded when it is earned, regardless of whether or not payment has been received; expenses are recorded when incurred. This method of accounting is referred to as the **accrual basis of accounting** and is the one used by paralegals as required under the *Income Tax Act*.[1] The **cash basis of accounting**

1 *Income Tax Act*, RSC 1985, c 1 (5th Supp), as amended.

recognizes revenue only when the revenue is actually received, and expenses only when payment has actually been made.

In the event that a client does not pay for fees billed, the firm would have to write the invoice off as a bad debt if it had already been included in income. Income recorded in the firm's records is taxed when it is earned, not when the client pays the bill.

- *Matching principle.* Expenses must be reported in the same period as the revenues that were earned as a result of the expenses.

TAX TIP

### Work in Progress

Lawyers and accountants receive special treatment when dealing with work in progress (WIP) under the *Income Tax Act.*[2] When lawyers file their first tax return, an election can be filed with the Canada Revenue Agency to report WIP only after it has been billed; then work that is in progress at the end of the fiscal period cannot be included in income. When this election is made, revenue is considered to have been earned when the bill is sent to the client and not before. The value of work done on a file is not included for tax purposes.

At the time of this printing, the *Income Tax Act* had not been amended to permit paralegals to file this election. The Act requires paralegals to include the value of WIP, even if the time spent on a file has not yet been billed to the client at the end of the fiscal period.

# Categories of Accounts

The books of a business are set up using three main categories of accounts: assets, liabilities, and owner's equity. Two further categories are revenue (or income) and expenses. Each category will have individual accounts listed under it.

The **chart of accounts** is a numbered list of all the business accounts used in a particular firm. A typical chart of accounts is printed on the inside cover of this textbook and shows the sample account names used in the book. You will notice that the five categories of accounts are broken down into account names. Individual accounts are given an account name and an account number.

Note that the account categories each have a number range. The table in Figure 2.1 shows how numbers might be assigned to each category and the **normal balance** for each.

| Account Name | Account Number (Range) | Normal Balance |
|---|---|---|
| Assets | 100–199 | Debit |
| Liabilities | 200–299 | Credit |
| Owner's equity | 300–399 | Credit |
| Revenue (income) | 400–499 | Credit |
| Expenses | 500–599 | Debit |

FIGURE 2.1 Categories of accounts

The accounts are numbered to make it easier to locate each account quickly. In other words, when you see an account numbered 300 you will know that it is listed under owner's equity. If the number is 500 you will know that it is an expense account. You should also note

2 *Ibid*, s 34.

that the list may skip over some numbers. This allows the addition of additional accounts if the bookkeeper decides in the future that a new account is needed.

Transactions are recorded in a **general journal** and then are summarized in the individual accounts listed in the chart of accounts in the form of a general ledger. The accounts are listed in the general ledger, and the totals from the general ledger are used to prepare financial statements. There are individual accounts for each of the subdivisions of the accounting equation (described below)—asset accounts, liability accounts, owner's equity accounts, income accounts, and expense accounts. These accounts are used to record increases and decreases in each category.

**Assets** are items of value that are owned by a business or a person. Assets are often broken down into current assets and fixed or capital assets. **Current assets** are cash, or assets that will be converted into cash or used up within one year. Examples are cash in bank accounts, accounts receivable, or prepaid insurance. **Fixed or capital assets** are assets that have a long life. Examples are land, buildings, equipment, and vehicles. Assets are not always purchased with cash. They often are purchased on credit.

**Liabilities** are debts owed to others by a business or a person. Examples of liabilities are personal or bank loans and accounts payable (if supplies or assets are purchased on credit). In a firm, the money held in trust for clients is also shown as a liability. Should the owner decide to close the business, liabilities would have to be paid off before the owner could receive a return on investment from the firm. Companies that are owed money are referred to as creditors.

**Owner's equity** represents the value of assets remaining after all liabilities have been deducted. The owner's net worth is represented by owner's equity. The amount of the investment by an owner in a firm is often referred to as capital. The equity account in an incorporated company is identified as **shareholder's equity**. Capital does not always mean cash; it may refer to the value of assets other than cash that have been invested in the firm by an owner.

**Income** is a subcategory of owner's equity and is revenue earned by the firm. Examples of income accounts are fees, income, interest income, and expense recovery.

**Expenses** are also a subcategory of owner's equity and represents the costs incurred of doing business. The Canada Revenue Agency allows the deduction of any reasonable current expense paid or an expense that will have to be paid for the purpose of earning business income.

# The Accounting Equation

The financial position of a business is stated in the form of the **accounting equation**. All transactions are analyzed using this basic accounting equation. You will encounter the terms *debit* and *credit* as you learn about the accounting equation. *Debit* refers to the left side of the equation; *credit* refers to the right side of the equation. More about the terms *debit* and *credit* will be covered in Chapters 3 and 4 of this book. To keep things simple, get used to thinking of these terms as meaning "left side" and "right side," and nothing more.

Assets = Liabilities + Owner's Equity

An essential component of the accounting system is **double-entry bookkeeping**. This system of **internal controls** requires that there be a check and a balance of the debits and the credits. There must be at least two entries for every transaction—one entry must be a debit entry and the other a credit entry.

We will introduce the application of the accounting equation by using the paralegal firm of Justin Case.

## EXAMPLE

Justin Case has decided to open his own paralegal practice as a sole proprietor. He plans to start the business by investing the following:

| | |
|---|---|
| Cash that he received as a graduation present | $1,000 |
| Money borrowed from his father | 4,000 |
| Total cash he has to deposit in the bank | $5,000 |
| His credit card debt (used to purchase assets) | $500 |
| Computer and printer that he bought for school; now valued at | $900 |
| Desk and office chair valued at | $150 |

### STEP 1

To apply the accounting equation to Justin's situation, list his assets in the accounts for cash, computer equipment, and office furniture.

| Assets | | |
|---|---|---|
| General Bank Account (cash) | $5,000 | |
| Computer Equipment | 900 | |
| Office Furniture | 150 | |
| Total Assets | $6,050 | |

### STEP 2

Calculate Justin's total liabilities by listing the accounts for the personal loan and credit card debt.

| | Liabilities | |
|---|---|---|
| | James Case (father), Loan | $4,000 |
| | Credit Card Debt | 500 |
| | Total Liabilities | $4,500 |

## Calculating Owner's Equity

### STEP 3

Calculate owner's equity by deducting the total liabilities or debts owed to creditors from the total assets. As you can see, the calculation yields an answer of $1,550 for owner's equity.

| Assets | | Liabilities | | Owner's Equity |
|---|---|---|---|---|
| 6,050 | − | 4,500 | = | ? |

### STEP 4

Check to ensure that the accounting equation is balanced.

Justin's assets are worth $6,050 and are equal to his liabilities plus owner's equity, which also equal $6,050.

We have included the cash borrowed from Justin's father in the listing of cash assets. Realistically, Justin has the cash; he also has a corresponding debt that is owed to his father and a credit card debt. Because he has total debts of $4,500, his equity in the firm is only $1,550.

In the event that Justin were to sell all his assets at the value shown in his books and he were to pay off all his debts, he would be left with $1,550.

Depending on which variable you are trying to calculate, the accounting equation can be stated in three ways:

| Assets | | Liabilities | | Owner's Equity |
|---|---|---|---|---|
| 6,050 | − | 4,500 | = | 1,550 |

$$\text{Assets } 6{,}050 = \underbrace{\text{Liabilities } 4{,}500 + \text{Owner's Equity } 1{,}550}_{6{,}050}$$

6,050 = 6,050

Assets = Liabilities + Owner's Equity

Assets − Liabilities = Owner's Equity

Assets − Owner's Equity = Liabilities

TAX TIP

## Accounting Software

Accounting software also uses the double-entry system of bookkeeping. All the principles that apply to manual record-keeping apply when using computer software.

Even though most accounting software is designed to detect errors, this does not mean that every transaction is always correct. Understanding accounting basics will help you locate errors regardless of what system you use.

# Preparing an Opening Balance Sheet

The **opening balance** is the total balance for each account at the beginning of each accounting period. The total is taken from the ending or **closing balance** of that account from the last period.

Justin Case, Paralegal
Opening Balance Sheet
Oct. 1, 20**

| | | | |
|---|---|---|---|
| Assets | | Liabilities | |
| General Bank Account (cash) | $5,000 | Personal Loan | $4,000 |
| Computer Equipment | 900 | Credit Card Debt | 500 |
| Office Furniture | 150 | Total Liabilities | $4,500 |
| | | Owner's Equity | |
| | | Justin Case, Capital | 1,550 |
| Total Assets | $6,050 | Total Liabilities and Owner's Equity | $6,050 |

FIGURE 2.2 Opening balance sheet

**Capital account** (here called Justin Case, Capital) refers to the investment by the owner in the business. Capital is not always cash; it can be assets that the owner chooses to invest in the business. The capital account includes the owner's beginning investment plus or minus the profits or losses earned by the firm. Any withdrawals by the owner will also reduce the amount in Justin Case's capital account.

# Expanded Accounting Equation

The **expanded accounting equation** takes into account three categories of accounts, in addition to assets, liabilities, and owner's equity:

1. **Withdrawals** refers to amounts taken out of the business for the personal use of the owner.
2. Income, as previously defined, refers to all earnings for the firm. In a paralegal firm, the main source of income is fees billed to clients. When clients are billed for services rendered, the amount of fees billed is entered immediately as income, regardless of whether or not the client has actually paid the bill. A firm could have other sources of income, such as interest income or expense recovery (such as charges for photocopies).
3. Expenses, as previously defined, are costs incurred by the business for the purpose of earning income. These include operating costs, such as advertising expense, dues and licences, interest, motor vehicle expenses, rent, telephone, and wages.

**Net income** is calculated by totalling the income of the firm minus expenses. This is often referred to as **profit** (when income exceeds expenses) or **loss** (when expenses exceed income). If revenues are lower than expenses, the firm will have a **net loss** (the calculation in which expenses exceed income, which causes a decrease in equity). If there is net income or profit from operations, the amount is added to the capital account with a resulting increase in the capital account. If there is a loss, it will be deducted from the capital account with a resulting reduction of the capital account. The capital account is the investment by the owner in the business.

The expanded accounting equation is stated as follows and is illustrated in Figure 2.3.

Assets = Liabilities + Capital − Withdrawals + (Income − Expenses)


FIGURE 2.3 The expanded accounting equation

Owner's equity typically is increased or decreased depending on the following conditions:

- *Investments made by the owner, such as cash, computer equipment, and office furniture, increase owner's equity* (this is also referred to as capital contribution).
- *Income from operation of the business increases owner's equity.* When profits are earned, they can be retained within the business to increase the owner's investment in the firm. For example, when profits are used to pay off a loan, the funds are being used to reduce the firm's liabilities and this results in an increase in owner's equity. If Justin in our example uses the profit from operations to pay off the loan to his father, his debt will decrease and his investment (capital) in the firm will increase.
- *Expenses from operation of the business will decrease owner's equity.* When the expenses are higher than revenues, a net loss results and the owner's equity is decreased.
- *Withdrawals by the owner will decrease owner's equity.* A sole proprietor does not receive a salary from the business. Instead, when the owner writes a cheque to himself for personal use, the amount withdrawn from the bank account results in a reduction of the amount of money in the general bank account as well as a reduction in the capital account of the owner. If the proprietor removes an asset other than cash from the firm, the transaction is recorded as a withdrawal and will reduce owner's equity in the firm.

Figure 2.4 shows how Justin's transactions and the expanded equation work together.

## Classifying Expenses

It can sometimes be difficult to decide whether something purchased is an asset or an expense. For example, Justin may go out and purchase office supplies at a cost of $1,000, including such items as pens, paper, and ink for printers. Should these items be recorded as assets (something of value owned by the business), or should they be recorded as expenses (something that will be used up within the fiscal period)?

| | ASSETS | | | | = | LIABILITIES | | | + | OWNER'S EQUITY | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Transaction | General Bank Account | Accounts Receivable | Computer Equipment | Office Furniture | = | Personal Loan | Credit Card Debt | Accounts Payable | + | J. Case Capital | − | Withdrawals | + | Fees Earned | − | Expenses |
| 1 | 5,000 | | 900 | 150 | | 4,000 | 500 | | | 1,550 | | | | | | |
| BAL | 5,000 | | 900 | 150 | = | 4,000 | 500 | | + | 1,550 | − | | + | | − | |
| 2 | −600 | | 600 | | | | | | | | | | | | | |
| BAL | 4,400 | | 1,500 | 150 | = | 4,000 | 500 | | + | 1,550 | − | | + | | − | |
| 3 | | | | 200 | | | | 200 | | | | | | | | |
| BAL | 4,400 | | 1,500 | 350 | = | 4,000 | 500 | 200 | + | 1,550 | − | | + | | − | |
| 4 | −1,000 | | | | | | | | | | | 1,000 | | | | |
| BAL | 3,400 | | 1,500 | 350 | = | 4,000 | 500 | 200 | + | 1,550 | − | 1,000 | + | | − | |
| 5 | 800 | | | | | | | | | | | | | 800 | | |
| BAL | 4,200 | | 1,500 | 350 | = | 4,000 | 500 | 200 | + | 1,550 | − | 1,000 | + | 800 | − | |
| 6 | | 1,200 | | | | | | | | | | | | 1,200 | | |
| BAL | 4,200 | 1,200 | 1,500 | 350 | = | 4,000 | 500 | 200 | + | 1,550 | − | 1,000 | + | 2,000 | − | |
| 7 | −300 | | | | | | | | | | | | | | | 300 |
| END BAL | 3,900 | 1,200 | 1,500 | 350 | = | 4,000 | 500 | 200 | + | 1,550 | − | 1,000 | + | 2,000 | − | 300 |

| TOTAL ASSETS | = | TOTAL LIABILITIES | + | TOTAL OWNER'S EQUITY | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | CAPITAL | | | + | PROFIT | | |
| | | | | 1,550 | − | 1,000 | + | 2,000 | − | 300 |
| 6,950 | | 4,700 | | 550 | | | + | 1,700 | | |
| 6,950 | = | 4,700 | + | 2,250 | | | | | | |
| 6,950 | = | 6,950 | | | | | | | | |

**TRANSACTIONS**

| | |
|---|---|
| 1 | Balances from the opening balance sheet were entered. |
| 2 | A shift in assets occurred. Computer equipment costing $600 was purchased and paid for using cash. Because cash was used to pay for the equipment, cash or the General Bank Account balance has been reduced, and there is an addition to the account for computer equipment. |
| 3 | Justin purchased $200 worth of office furniture from a furniture store on credit. Justin has not used cash to pay for the item, but he now owes the store $200, which is recorded under Accounts Payable. Justin has increased what he owes to creditors. |
| 4 | Justin needed money to pay for personal expenses, so he withdrew $1,000 from the firm's bank account. This withdrawal results in a reduction in the General Bank Account and is shown in Owner's Equity under Withdrawals. |
| 5 | Legal fees of $800 were invoiced to a client and the client paid the bill. The transaction provided an inward flow of cash in the General Bank Account and an increase in income as a result of legal fees charged. |
| 6 | Legal fees of $1,200 were invoiced to a client and the client has not paid the bill. These fees billed are an asset for the firm called Accounts Receivable and an increase in legal fees. |
| 7 | Justin paid one month's rent in the amount of $300. This is an expense (rent expense), which reduces Owner's Equity as well as the General Bank Account balance. |

FIGURE 2.4 Demonstration of expanded accounting equation

There are different ways to handle such an entry. Justin may want to show the supplies as an asset (which Justin has numbered account 130) and at the end of the period do an inventory and record what has been used up. He would expense only the amount that was used, leaving the balance in the asset portion of the balance sheet. If the amount purchased is small, it will be easier for Justin to simply record the purchase as office supplies expense (numbered as account 535).

# Recording the Opening Balance Sheet in the Firm's Records

The numbers from the opening balance sheet are recorded in the firm's general journal when the firm's books are first set up. These entries are then posted to the firm's general ledger accounts as opening entries.

| Justin Case, Paralegal<br>General Journal | | | | | GJ1 |
|---|---|---|---|---|---|
| *Date 20*** | | *Description* | *PR* | *Debit* | *Credit* |
| Oct. | 1 | General Bank Account | 100 | 5,000 | |
| | | Computer Equipment | 155 | 900 | |
| | | Office Furniture and Equipment | 158 | 150 | |
| | | Personal Loan | 205 | | 4,000 |
| | | Credit Card Debt | 210 | | 500 |
| | | Justin Case, Capital | 300 | | 1,550 |
| | | *To record opening balance sheet* | | | |
| | | Totals | | 6,050 | 6,050 |

FIGURE 2.5 Opening entries

1. The balances from the opening balance sheet are recorded in the general journal. This is referred to as the "book of original entry" because transactions are always recorded first in a general journal. The heading indicates that the page number is 1 (GJ1), which is the first page of the general journal.
2. The month and year are placed in the first column for the first entry. We did not repeat the month for entries that follow because the date did not change.
3. Note that the debit entries in the Description column are placed at the margin and the credit entries are indented three spaces.
4. The post reference (PR) column (which will be explained in more detail in later chapters) shows the number of the general ledger account to which the amount was posted. The account number is entered only after the number has been recorded in the firm's general ledger.
5. "To record opening balance sheet" is the description of the general journal entries above.

# Recording Transactions Using the Basic Accounting Equation

The **T-accounts** shown below illustrate how posting the opening entries affects the individual ledger accounts. The total debits equal the total credits once all posting is completed.

**General Bank Account**

| Dr. | Cr. |
|---|---|
| 5,000 | |

**Computer Equipment**

| Dr. | Cr. |
|---|---|
| 900 | |

**Office Furn. & Equip.**

| Dr. | Cr. |
|---|---|
| 150 | |

**Personal Loan**

| Dr. | Cr. |
|---|---|
| | 4,000 |

**Credit Card Debt**

| Dr. | Cr. |
|---|---|
| | 500 |

**Justin Case, Capital**

| Dr. | Cr. |
|---|---|
| | 1,550 |

Total Debits = 6,050 Total Credits = 6,050

FIGURE 2.6 T-accounts showing ledger balances after posting

## CHAPTER SUMMARY

One of the first challenges a paralegal starting a firm might encounter is obtaining financing for the business. This involves preparing a business plan that presents the investment being made and forecasts the anticipated income and expenses. Knowing the language of accounting will help you to communicate your plans and needs to an investor, whether a financial institution or an individual. You want to understand the general principles applied in maintaining records and be able to present a financial plan in a professional manner when asked to do so. Many situations may require you to be conversant with the language and principles that apply to record-keeping.

Understanding debits and credits takes time, and the aim of this chapter is merely to introduce you briefly to some transactions. You have seen the categories of accounts and know why you need to have a chart of accounts. The intricacies of debit and credit will be explored in more detail in the chapters that follow.

## KEY TERMS

accounting equation, 21
accounting standards for private enterprises (ASPE), 19
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## FURTHER READING

*CPA Canada Handbook: Accounting* (Toronto: Chartered Professional Accountants of Canada, 2015), online: <http://www.cpacanada.ca>.

Nortel Networks Corporation
<http://www.nortel.canada.com>.

*In re Nortel Networks Corp Securities Litigation*, Master File No 04 Civ 2115 (LAP) (10 September 2004 and 16 September 2005).

*Nortel Networks Corporation (Re)* (2009), 55 CBR (5th) 229, 2009 CanLII 39492 (Ont Sup Ct).

*Ontario Public Service Employees Union Pension Trust Fund v Clark* (2005), 77 OR (3rd) 38, 2005 CanLII 51027 (Sup Ct).

*Re Nortel Networks Corporation* (2006), 29 OSC Bull 8608.

# PUT IT INTO PRACTICE

## Case Example: Accounting Standards

### Nortel Networks

The *Nortel Networks* case is an infamous and well-documented example of the lack of oversight and compliance with accounting standards in the corporate context.

Since as early as 2001, various class-action proceedings and other lawsuits were commenced against Nortel Networks Corporation, a telecommunications company, and its directors and officers for discrepancies in the company's financial reporting. The affected stakeholders were internal, external, and international in nature. For example, the government securities regulator in Canada and the United States brought charges against the company; current and former employees joined in a class action to protect themselves from losses on their pension plans as well as employment interruptions as a result of Nortel's financial losses; and shareholders and investors were defrauded and misinformed about the company's financial health. In 2009, Nortel filed for bankruptcy protection under the *Companies' Creditors Arrangement Act* (CCAA) in Ontario. Appeals and motions against the company are still before the courts, and the fallout from Nortel's decisions since 2000 continues.

Some of the charges laid against the company include these from the class-action suit[3] brought by David Lucescu, individually, and on behalf of other shareholders against Nortel:

- Statements made by the company about its financial position were materially false and misleading (para 28).
- The financial results made by the company were materially overstated (para 28).
- "The [defendants] lacked a reasonable basis for their positive statements about the Company, its business, operations, earning and prospects" (para 28).
- The defendants "materially misled the investing public, thereby inflating the price of Nortel common stock, by publicly issuing false and misleading statements and omitting to disclose material facts necessary to make Defendant's statements, as set forth herein, not false and misleading. Said statements and omissions were materially false and misleading in that they failed to disclose material adverse information and misrepresented the truth about the Company, its business and operations, as alleged herein" (para 36).

See the Further Reading section above for this case and related cases.

Use the table below to identify and discuss the accounting standards and generally accepted accounting principles (GAAP) that Nortel violated based on the charges identified in the class action against Nortel Networks.

| | Action taken by/charge laid against Nortel | Accounting principle/standard violated |
|---|---|---|
| 1. | The company made materially false and misleading statements about its financial position | · Reliability · Relevance · Going concern principle |
| 2. | The financial results were materially overstated | |
| 3. | There was no reasonable basis for the company's positive outlook | |
| 4. | The company materially misled the investing public | |
| 5. | The company's stock value was overinflated | |
| 6. | The company failed to disclose adverse material facts | |
| 7. | The company misrepresented the truth about the company, its business, and its operations | |

3 See <http://securities.stanford.edu/filings-documents/1043/NTL09_01/2009518_f01c_0904691.pdf>.

# REVIEW QUESTIONS

## True or False

_____ 1. Cash and capital are equivalent terms that can be used interchangeably.

_____ 2. Going concern is one of the principles of accounting.

_____ 3. In accrual accounting, cash must be received before the transaction is recognized on the financial statement.

_____ 4. For every transaction reported on a financial statement, there are at least two entries.

_____ 5. A chart of accounts is a standardized list of accounts that is only created using accounting software.

_____ 6. Businesses are concerned only about external stakeholders in their financial reporting.

_____ 7. Paying down a bank loan or other forms of credit will decrease equity.

_____ 8. Purchasing or selling assets will increase equity.

_____ 9. The balance sheet and the statement of financial position mean the same thing.

_____ 10. The general journal is an example of a book of original entry.

_____ 11. Business owners take money out of their business by way of a salary.

_____ 12. The equity account for a corporation is typically identified as shareholder's equity.

## Short Answer

Give a full answer for each question:

1. What are the steps involved in entering transactions in the general journal?
2. What does it mean to understand the financial position of your business (or even your personal finances)?
3. Which accounts have an impact on owner's equity?

# PRACTICE EXERCISES

## Practice Exercise 2.1

Using the definitions explained in this chapter, determine the classification (assets, liabilities, owner's equity, income, and expenses) of each of the following account names. If necessary, refer to the chart of accounts on the inside front cover of this textbook.

| | *Account name* | *Category* |
|---|---|---|
| 1 | Cash | Asset |
| 2 | Motor Vehicle | |
| 3 | Telephone Expense | |
| 4 | Salaries and Wages | |
| 5 | Professional Fees | |
| 6 | Capital | |
| 7 | Computer Equipment | |
| 8 | Accounts Receivable | |
| 9 | Advertising Expense | |
| 10 | Interest Earned | |
| 11 | Prepaid Rent | |
| 12 | General Bank Account | |
| 13 | Office Equipment | |
| 14 | Withdrawals | |

## Practice Exercise 2.2

Balance the accounting equation on each line by calculating the value of the missing number represented by a question mark.

| | Assets | = | Liabilities | + | Owner's Equity |
|---|---|---|---|---|---|
| Example: | 35,000 | = | 15,000 | + | ? |
| | Answer: 35,000 – 15,000 = 20,000 | | | | |
| 1 | 40,000 | = | 10,000 | + | ? |
| 2 | 80,000 | = | ? | + | 60,000 |
| 3 | ? | = | 24,000 | + | 10,000 |
| 4 | ? | = | 5,000 | + | 10,000 |
| 5 | 20,000 | = | ? | + | 6,000 |
| 6 | 31,000 + ? | = | 24,000 | + | 10,000 |
| 7 | 58,500 | = | 2,500 | + | 80,000 – ? |
| 8 | 1,700 + 5,000 | = | ? | + | 700 |
| 9 | ? | = | 10,000 | + | 30,000 |
| 10 | 20,000 – 5,000 | = | 5,400 + ? | + | 8,000 |

## Practice Exercise 2.3

In the following list of accounts, complete the table as follows:

a. Indicate the category of account: asset, liability, capital, withdrawal, income, or expense.

b. Indicate the normal balance for that category of account.

c. Indicate whether the balance in the account increases or decreases when an entry is made on the side indicated.

| | *Account name* | *Category* | *Normal balance* | *Side* | *Increases/ decreases* |
|---|---|---|---|---|---|
| 1 | Accounting and Bookkeeping Expense | Expense | Debit | Dr. | Increases |
| 2 | Accounts Payable/General | | | Dr. | |
| 3 | Auto Expense | | | Cr. | |
| 4 | Credit Card Debt | | | Cr. | |
| 5 | Fees Earned | | | Cr. | |
| 6 | General Bank Account | | | Dr. | |
| 7 | Insurance—Prof. Liability | | | Dr. | |
| 8 | Interest Income | | | Cr. | |
| 9 | Accounts Payable/General | | | Dr. | |
| 10 | Office Furniture | | | Dr. | |
| 11 | Owner, Capital | | | Cr. | |
| 12 | Owner, Drawings | | | Cr. | |
| 13 | Photocopy Expense | | | Dr. | |
| 14 | Prepaid Insurance | | | Dr. | |
| 15 | Prepaid Rent | | | Cr. | |
| 16 | Salaries | | | Dr. | |
| 17 | Utilities | | | Cr. | |
| 18 | Vacation Accrual Payable | | | Cr. | |
| 19 | General Bank Account | | | Cr. | |

## Practice Exercise 2.4

**Using the worksheet provided, complete the expanded accounting equation by recording the following transactions.**

| | |
|---|---|
| **1** | Balances from the opening balance sheet were entered by Ann Litigate. She had invested $8,000 in her firm. |
| **2** | Office equipment costing $800 was purchased and paid for using cash. |
| **3** | Ann purchased $900 worth of office furniture from a furniture store on credit. |
| **4** | Ann paid for personal expenses from the firm's bank account in the amount of $1,500. |
| **5** | Legal fees of $1,600 were invoiced to a client and the client paid the bill. |
| **6** | Legal fees of $800 were invoiced to a client and the client has not paid the bill. |
| **7** | Ann paid one month's salaries expense in the amount of $2,000. |

| | ASSETS | | | = | LIABILITIES | + | OWNER'S EQUITY | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Transaction** | **General Bank Account** | **Accounts Receivable** | **Office Furniture and Equipment** | = | **Accounts Payable** | + | **A. Litigate Capital** | – | **Withdrawals** | + | **Fees Earned** | – | **Expenses** |
| 1 | 8,000 | | | | | | 8,000 | | | | | | |
| BAL | 8,000 | 0 | 0 | = | 0 | + | 8,000 | – | 0 | + | 0 | – | 0 |
| 2 | | | | | | | | | | | | | |
| BAL | | | | = | | + | | – | | + | | – | |
| 3 | | | | | | | | | | | | | |
| BAL | | | | = | | + | | – | | + | | – | |
| 4 | | | | | | | | | | | | | |
| BAL | | | | = | | + | | – | | + | | – | |
| 5 | | | | | | | | | | | | | |
| BAL | | | | = | | + | | – | | + | | – | |
| 6 | | | | | | | | | | | | | |
| BAL | | | | = | | + | | – | | + | | – | |
| 7 | | | | | | | | | | | | | |
| END BAL | | | | = | | + | | – | | + | | – | |

| TOTAL ASSETS | = | TOTAL LIABILITIES | + | TOTAL OWNER'S EQUITY | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | CAPITAL | | + | PROFIT | | |
| | | | | | – | + | | – | |
| | | | | | | + | | | |
| | = | | + | | | | | | |
| | = | | | | | | | | |

## Practice Exercise 2.5

For each of the following transactions, (a) identify the two account names and the account type using the chart of accounts printed on the inside cover of this textbook and (b) identify the appropriate financial statement: balance sheet, statement of owner's equity, or income statement. Hint: Don't forget the double-entry accounting principle.

| Transaction | Account Name/Type | Financial Statement |
|---|---|---|
| 1. Paralegal contributed $10,000 to the legal services firm from personal funds. | | |
| | | |
| 2. Paralegal took a draw ($1,200) against the legal services firm's equity for personal use. | | |
| | | |
| 3. Paralegal purchased a new all-in-one printer for the office ($350) with cash. | | |
| | | |
| 4. Paralegal paid bookkeeper for bookkeeping services ($1,000) with cash. | | |
| | | |
| 5. Paralegal paid office rent, which included utilities and telephone ($1,500), with cash. | | |
| | | |
| 6. Paralegal billed a client for professional fees and received payment from the client ($1,700). | | |
| | | |
| 7. Paralegal paid Law Society dues ($1,100). | | |
| | | |
| 8. Paralegal paid principal and interest on her bank loan ($500 principal; $100 interest). | | |
| | | |
| | | |
| | | |

## Practice Exercise 2.6

Using the transactions from Practice Exercise 2.5, complete the following accounting equations.

Assume that the opening balances are as follows: Assets: $5,000; Liabilities: $2,500; and Owner's Equity: $2,500 (Capital). List each transaction entry under the appropriate heading of the expanded accounting equation. Hint: Decreases in the debit or credit record should be expressed as a negative using brackets ( ).

**Ann Litigate Paralegal Services**
**May 1 – May 30**

| TRANSACTION | ASSETS | | LIABILITIES | | OWNER'S EQUITY | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | = | | + | Capital | – | Withdrawals | + | Revenue | – | Expenses |
| Opening | 5,000 | = | 2,500 | + | 2,500 | – | | + | | – | |
| 1 | | = | | + | | – | | + | | – | |
| 2 | | = | | + | | – | | + | | – | |
| 3 | | = | | + | | – | | + | | – | |
| | | | | | | | | | | | |
| 4 | | = | | + | | – | | + | | – | |
| 5 | | = | | + | | – | | + | | – | |
| 6 | | = | | + | | – | | + | | – | |
| 7 | | = | | + | | – | | + | | – | |
| 8 | | = | | + | | – | | + | | – | |
| Ending Balance | | = | | + | | – | | + | | – | |
| PROOF | | = | | | | | | | | | |

## Practice Exercise 2.7

Complete the T-account chart based on the opening balances provided for each account and the transactions listed. Calculate the ending balance for each account. Opening balances are shown in green.

| | |
|---|---|
| **1** | Withdrew $5,000 from legal practice for personal use. |
| **2** | Billed and received payment for legal services rendered, $2,300 (Client A). |
| **3** | Received payment for legal services rendered, $1,800 (Client B). This client was billed previously and an account receivable for the amount of the account had been recorded at that time. |
| **4** | Paid supplier for legal texts, $400. |
| **5** | Paid process server for filing court documents, $130. |
| **6** | Paid for Internet and business email services, $105. |
| **7** | Obtained business line of credit, $15,000. |
| **8** | Paid interest on bank loan, $85. |

**General Bank Account**

| Dr. | Cr. |
|---|---|
| 8,000 | |

**Accounts Receivable**

| Dr. | Cr. |
|---|---|
| 3,000 | |

**Liabilities**

| Dr. | Cr. |
|---|---|
| | 2,000 |

**Owner's Equity**

| Dr. | Cr. |
|---|---|
| | 9,000 |

**Professional Fees Earned**

| Dr. | Cr. |
|---|---|

**Expenses**

| Dr. | Cr. |
|---|---|